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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the district court (R. 15–22)[1] is reported at 216 F. Supp. 457. The opinion of the court of appeals (App. 1a–22a)[1] is reported at 333 F. 2d 389.

JURISDICTION

The judgment of the court of appeals was entered on May 25, 1964 (App. 22a). By order of Mr. Justice White, dated August 22, 1964, the time for filing a petition for a writ of certiorari was extended to and

[1] "R." refers to the Transcript of Record filed in the court of appeals; "App." to the appendix to this petition.

including September 11, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the constitutional doctrine prohibiting a tax on interest from State and municipal bonds requires Congress, in allocating a life insurance company's income between an untaxed "policyholder's share" and a taxed "company's share", to allocate all of the municipal bond interest to the company's share, thereby entitling the company to deduct the full amount of such interest from its share of the income. In the terms of the statute, the question is whether the definitions of "taxable investment income" and "gain from operations" in the Life Insurance Company Income Tax Act of 1959, by allocating the municipal bond interest pro rata between the two shares, result in an "imposition of tax on" municipal bond interest, thereby precluding the application of those definitions under the "exception" clauses of the statute (§§ 804(a)(6), 809(b)(4), Internal Revenue Code of 1954).

STATUTES INVOLVED

The relevant portions of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, are set forth in Appendix B, *infra*, pp. 23a–30a.

STATEMENT

Under the Life Insurance Company Income Tax Act of 1959 (§§ 801–820 of the Internal Revenue Code of 1954, as amended), the taxable income of a life insurance company includes the full amount of its "gain

from operations" up to the amount of its "taxable investment income," plus one-half of any additional "gain from operations" (§ 802(b)). "Taxable investment income" and "gain from operations" are defined in detail in §§ 804(a) and 809(b), respectively, but each of those provisions contains an "exception" providing that, if the application of the definition "results in the imposition of tax on" State and municipal bond interest, "adjustment shall be made to the extent necessary to prevent such imposition" (§§ 804(a)(6), 809(b)(4)).

In its income tax return for 1958, respondent computed its income in accordance with the statutory definitions of "taxable investment income" and "gain from operations." In due course, however, it brought this suit for refund contending that the application of the statutory definitions resulted in the imposition of tax on its municipal bond interest. The court of appeals, reversing the district court, held that the statute does impose a tax on municipal bond interest and, to eliminate that effect, adjusted respondent's tax under the "exception" clauses.

A fuller statement of the issue and of the reasoning of the court below requires an explanation of the nature of life insurance reserves and of the statutory plan for the taxation of life insurance companies. Since the statutory definitions of "taxable investment income" and of "gain from operations" present the same issue but require somewhat different computations, we will for simplicity hereafter confine the discussion, except as otherwise expressly noted, to the definition of "gain from operations," the definition

that requires the simpler and more easily understood computations.[2]

1. *Life insurance reserves.*—The premiums charged for life insurance are calculated on the assumption that the premiums received by the company will be invested and earn interest which, when added to the accumulated premiums, will be sufficient to pay the policyholders' claims as they accrue. The rate of interest assumed in determining premiums is also employed in computing the "reserve" for policyholder claims which State law normally requires the company to maintain. The reserve is computed as that amount which, with an annual growth at the assumed rate of interest, will be sufficient (with the future premiums) to pay the actuarially-predicted policyholder claims. The mortality tables and the assumed rate of interest used in the computations are regulated by State law, and if the net assets of the company fall below the reserve so computed, the company is deemed insolvent and may no longer continue in business.

Since the reserve is computed by "discounting" the predicted policyholder claims to the present at the assumed rate of interest, it is obviously necessary,

[2] The selection of "gain from operations" for the major exposition can also be justified on the ground that, if anything, it is the measure that has the greater impact on the company's final taxable income. Changes in "gain from operations" will always affect taxable income by at least 50% of the amount of the change, and sometimes (when it is less than "taxable investment income") by 100%. Changes in "taxable investment income," on the other hand, never affect taxable income by more than 50% of their amount, and sometimes (when it exceeds "gain from operations") not at all. See § 802(b).

if the reserve is to continue to measure the company's ability to meet its policyholder obligations, that the reserve be increased each year by an amount equal to the interest that it was assumed the assets represented by the reserve would earn. Thus, out of the income earned each year from the investment of the premium receipts, a certain portion must be "set aside" and added to the reserve to "fund" the anticipated policyholder obligations. It is the tax treatment of the annual additions to the reserve that gives rise to this litigation.

2. *The statute.*—The present statute continues in a new form the longstanding policy of Congress not to tax the portion of a life insurance company's income that is required to be set aside as an addition to the reserve. The statute initially provides that in computing "gain from operations", the "investment yield" (investment income less investment expenses) is to be divided between the "policyholders' share" and the "company's share." The amount allocated to the policyholders is equal to the assumed interest rate times the reserves (the "required interest," § 809(a)(2)) and thus represents the amount required to be added to the reserves to fund the predicted policyholder claims. The amount allocated to the company is simply the balance. The "policyholders' share" so determined is wholly excluded from the company's income and only the "company's share" enters into its "gain from operations." In short, the company is taxed only on the excess of the investment income over the amount required to be added to the reserves.

The total investment income is, of course, composed of many different kinds of income (dividends, royalties, rents, taxable interest, tax-exempt interest, *etc.*), and it is therefore further necessary to say of what kinds of income the "policyholders' share" and the "company's share" are to be deemed composed. The statute solves that problem by allocating each item of income pro rata between the two shares. Thus, if the required addition to the reserve is $800,000 and the investment yield for the year is $1,000,000, 80% of each item of income is allocated to the policyholders and excluded from the company's income. The $200,000 allocated to the company is deemed to be composed of the remaining 20% of each item of income and is taxed accordingly, with the appropriate deductions then being allowed for tax-exempt interest, intercorporate dividends, *etc.* If, for example, the $1,000,000 investment yield included $100,000 of tax-exempt interest, the company's $200,000 share of the total investment yield would be deemed to include $20,000 (*i.e.*, 20%) of the tax-exempt interest and would accordingly be reduced by that amount, leaving $180,000 to be included in gain from operations. The other $80,000 of tax-exempt interest is deemed to have been already excluded as a part of the policyholders' $800,000 share of the total income, so that no further exclusion on its account is required.[3]

[3] The method of computing "taxable investment income" is substantially identical except that, in determining the amount of income to be allocated to the policyholders (called the "policy and other contract liability requirements"), the reserves are multiplied, not by the assumed rate of interest (as in computing "gain from operations"), but by the rate of return

The necessary effect of the statutory formula is that the receipt of tax-exempt interest will cause the company's "gain from operations", and hence its tax liability, to be higher than it would have been if that interest had not been received. That may be seen by comparing the example just given ($1,000,000 investment yield including $100,000 of tax-exempt interest, which produces $180,000 of taxable gain from operations) with the result that would be reached if the tax-exempt interest were eliminated, leaving $900,000 of investment yield composed entirely of taxable items. Because the "required interest" is a fixed amount (reserves times assumed interest rate) determined without reference to investment yield, the amount allocated to the policyholders would still be the same $800,000 and only $100,000 would be left as the company's share to be included in "gain from operations." Thus the receipt of an additional $100,000 of income in the form of tax-exempt interest causes "gain from operations" to be increased by $80,000.

The explanation of that result is simple. Because the absolute amount of income allocated to the policy-

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actually realized by the company from the investment of its assets (either during the current year or, if lower, during the past five years) (§ 805). The effect of using the earnings rate rather than the assumed rate is dampened, however, by a further adjustment which reduces the amount so determined by 1% for every tenth of a percentage point by which the earnings rate exceeds the assumed rate; if the earnings rate is less than the assumed rate, the amount is increased by the same ratio (§ 805(c)(1)(B)). The net effect is the same as though the reserves were multiplied by a rate somewhere in between the assumed rate and the earnings rate.

holders is a constant (equal to the "required interest"), the *fraction* of the investment yield that must be allocated to them decreases as the investment yield increases. To give the policyholders $800,000 requires 100% of an investment yield of $800,000; 88.9% of a yield of $900,000; and only 80% of a yield of $1,000,000. By increasing the investment yield, therefore, the receipt of tax-exempt interest reduces the fraction of all the other income that must be allocated to the policyholders, thus leaving a larger part of the other income to be included in the company's gain from operations. In short, the reason that the receipt of tax-exempt interest causes an increase in tax is simply that it provides a larger base out of which the fixed claims of the policyholders can be satisfied, thus reducing their claims against the taxable items of income.[4]

Having defined "gain from operations" in a way necessarily causing it to be increased upon the receipt of municipal bond interest—the inevitable result of the pro rata allocation of such interest between the "policyholder's share" and the "company's share"—the statute concludes with the "exception" clause on

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[4] The described consequences are those of the receipt of *additional* income in the form of tax-exempt interest. Very different is the case of a *substitution* of tax-exempt income for taxable income, which results instead in a decrease in tax fully commensurate with the extent to which the company's taxable income is taxed. With a fully taxable investment yield of $1,000,000 and a policyholder's share of $800,000, only 20% of the investment yield would be included in gain from operations. Commensurately, gain from operations would be reduced by 20% of any part of the investment yield that was shifted from taxable income to tax-exempt income.

which the decision below was based. That clause (§ 809(b)(4)) provides that:

> If it is established in any case that the application of the definition of gain from operations * * * results in the imposition of tax on [municipal bond interest, *inter alia*] * * *, adjustment shall be made to the extent necessary to prevent such imposition.

3. *Facts and proceedings below.*—During 1958, respondent received interest on municipal bonds in the amount of $36,637. Its total "investment yield," including that interest, was $894,277. The "required interest" on its reserves was $781,540 (App. 6a).

In its income tax return for 1958, respondent computed its "gain from operations" in accordance with the statutory definition. A part of the investment yield ($894,277) equal to the required interest on the reserves ($781,540) was excluded as the "policyholders' share," leaving $112,737 as the "company's share." The company's share, being 12.6% of the total investment yield, was treated as including 12.6% of the municipal bond interest, or $4,619. A deduction was taken for that amount, leaving $108,118 as the net investment income to be included in gain from operations.

In its claim for refund and in the proceedings below, respondent contended that the application of the statutory definition "result[ed] in the imposition of tax on" its municipal bond interest because it resulted in a higher gain from operations (and hence tax) than there would have been if it had not received the tax-exempt interest. To prevent that result, it contended that its gain from operations should be recomputed

under the "exception" clause by eliminating the municipal bond interest from the "investment yield" at the outset, reducing the investment yield to $857,640. The same amount would then be excluded as the "policyholders' share" ($781,540), leaving only $76,100 as the net investment income to be included in gain from operations. The resulting $32,018 reduction in gain from operations is exactly equal, it may be seen, to the portion of the municipal bond interest (87.4%) which the statutory formula allocated to the policyholders. The essential difference in the computations is that the statutory formula treats the amount allocated to the policyholders as consisting of a pro rata part of every item of income, including municipal bond interest, while respondent's computation allocates to the policyholders only taxable items of income and allocates all of the municipal bond interest to the company.

The district court held that respondent was not being taxed on its municipal bond interest under the statutory definitions and denied the refund. The court of appeals reversed. It construed this Court's decisions in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, and *Missouri Insurance Co.* v. *Gehner,* 281 U.S. 313, as meaning that a tax is unconstitutionally imposed "on" tax-exempt interest whenever "the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest" (App. 20a). By that standard, a tax was being imposed "on" respondent's municipal bond interest, since its tax was greater than it would have been if that interest had not been received. Since the court

considered itself bound by the *National Life* and *Gehner* decisions as to what constitutes a tax "on" tax-exempt interest, and since any challenge to the constitutional immunity of municipal bond interest from taxation was pretermitted by the "exception" clauses of the statute, the court held that respondent was entitled to adjust its tax, under the "exception" clauses, to what it would have been if the municipal bond interest had not been received. Specifically, the court approved respondent's reduction of its "gain from operations" from $108,118 (the result under the statutory definitions) to $76,100 (the result under respondent's method of computation described above).

REASONS FOR GRANTING THE WRIT

The decision of the court below, in what is regarded as a "test case" by the life insurance industry, strikes down a carefully formulated statutory plan for the taxation of life insurance companies. It will subject the government to as many as 8,000 claims for refund of approximately $400,000,000 for the years 1958–1964. For the future, the decision, if followed, would cause a revenue loss of several hundred million dollars a year.

1. Since 1921 Congress has wrestled with the relationship between the tax exemption of interest on obligations of a State (or State subdivision) and the deduction or exclusion of income attributed to a life-insurance reserve held for policyholders. In 1959, after prolonged hearings and consultation with all the interested parties and after unusually detailed

Congressional consideration, Congress enacted an elaborate new plan of taxation of life insurance companies. Adoption of the statute was urged by life insurance companies holding more than 70 percent of all life insurance company assets (105 Cong. Rec. 8401–8402) as well as by the Treasury Department.

That carefully devised plan has been nullified by the decision below. Its cornerstone is the treatment of the excluded "policyholders' share" as consisting of a pro rata part of each item of income, including tax-exempt interest, thus leaving in the company's hands, to be claimed as a further deduction, only the remaining fraction of the tax-exempt interest. Since the receipt of additional tax-exempt interest does not increase the exclusion for the policyholders' share of the total income, and increases the deduction for tax-exempt interest only by a fraction of its amount, the receipt of such interest necessarily causes a net increase in the company's "gain from operations" and hence its tax liability. That occurs, not because of any circumstance peculiar to this case, but because it is inherent in—and was the intended result of—the statutory definition of "gain from operations." The holding of the court below that a tax is imposed "on" tax-exempt interest, requiring an adjustment under the "exception" clause, whenever the receipt of tax-exempt interest causes the tax to be higher thus wholly destroys the statutory plan. Its effect is to strike from the statute the elaborate formula for the division of each item of income between the "policyholders' share" and the "company's share" and to

substitute in every case a judge-made "adjustment" under the "exception" clause.[5]

The holding below is no less an effective invalidation of a provision of an Act of Congress than would have been a holding that the statute was unconstitutional—which was, indeed, the context in which the cases relied upon by the court below arose. The only difference is that the "exception" clause precludes any challenge to the immunity of State and

[5] It is admitted that the same result will *normally* occur also under the definition of "taxable investment income", but whether it will *necessarily* occur depends upon what assumptions are made in computing what the taxable investment income "would have been" without the tax-exempt interest. "Taxable investment income" computed under the statutory definition will always be greater than it would have been if the company had not had the municipal bonds. It will usually, but not necessarily always, be greater than it would have been if the company had had the bonds but had not received the interest, which is the assumption respondent and the court of appeals employed in recomputing respondent's taxable investment income. Leaving the bonds in the company's assets but removing the interest from the investment yield causes a marked reduction in the earnings rate (investment yield divided by assets) and thus in the amount of income allocated to the policyholders (reserves times earnings rate, see note 3, *supra*). The reduced exclusion for the policyholders' share tends to offset the reduction in the investment yield, and in extreme circumstances can wholly offset it. The justification for using wholly disparate factors in computing the earnings rate (dividing both taxable and exempt assets into the income from the taxable assets alone) is not apparent, however. Nor is it apparent why respondent and the court below are willing to tolerate the inclusion of tax-exempt bonds in the asset account when the effect is to increase taxable investment income. By the court of appeals' standard, that results in imposing a tax "on" the bonds themselves which, if anything, is surely more objectionable than imposing a tax merely on the interest from the bonds.

municipal bonds from taxation. Fearful that a full defense of the constitutionality of its statute might involve an attack upon the whole doctrine of intergovernmental immunities, and wishing to preserve the basic immunity of municipal bond interest regardless of constitutional compulsion, Congress postulated that a tax on municipal bond interest was constitutionally impermissible and left open for litigation only the question whether the taxing plan it adopted imposed a tax "on" such interest. But while the question is presented in the context of a statutory caveat, avoiding the necessity of an ultimate decision of constitutionality, it cannot rightly be seen as a question of statutory interpretation in the usual sense. Since Congress obviously did not "intend" by the exception clause to retract the taxing formula it simultaneously enacted, the question whether the statute imposes a tax "on" municipal bond interest cannot be answered by asking what Congress meant by "on." In essence, the exception clause asks a hypothetical constitutional question and says what shall happen if the question is answered adversely to the statutory formula. The question is: Assuming the continuing vitality of the doctrine that a tax may not constitutionally be imposed on the interest from State and municipal bonds, would this statute be unconstitutional as imposing such a tax? If the answer is "yes", the statute provides a remedy and

thus precludes any challenge to the premise of that question.[6]

But whether seen as a statutory or a quasi-constitutional decision, the fact remains that the decision renders nugatory and unenforceable the key feature of the Life Insurance Company Income Tax Act of 1959—to wit, the division of each item of income pro rata between the "policyholders' share" and the "company's share." In the place of the pro rata allocation of the statute, the decision requires that 100% of the municipal bond interest be allocated to the company and that only taxable items of income be allocated to the policyholders. And since that is said to be the only treatment consistent with the postulated immunity of municipal bond interest from taxation, the decision would force Congress to continue to use that method of allocation in any future legislation, however arbitrary it may seem, unless it is willing directly to assert a power to tax municipal bond interest. In the present statute, Congress carefully avoided a test of that power, believing that it could tax life insurance companies in the manner attempted in the Act without impinging upon the supposed immunity of interest on

[6] In addition to pretermitting the question of immunity *vel non*, the "exception" clause performs a second important function. When the predecessor statute was held unconstitutional in the *National Life* case, there was left a difficult question whether the consequence should be to strike down the whole taxing statute, the entire deduction for additions to the reserve, or only the limitation on the deduction (see 277 U.S. at 534–535 (Brandeis, J., dissenting)). The "exception" clause of the new statute avoids that problem by providing statutory authority for a judicial "remodeling" of the statute should it be held "unconstitutional" as written.

governmental obligations from taxation by another sovereign. Congress, we submit, is entitled to the judgment of this Court on the correctness of that belief before it is remanded to the hard choice between either (a) allowing life insurance companies to enjoy what it reasonably considers to be a doubling up of tax benefits or (b) precipitating a major constitutional decision on the power of the Federal and State governments to tax the interest paid on each other's obligations.

2. Staggering amounts of revenue turn upon the issue. The Treasury estimates that acceptance of the decision below would render the United States subject to $400,000,000 in refund claims with respect to tax-exempt interest and the dividends-received deduction for the years 1958–1964.[7] The amounts estimated to be involved for future years range from a figure of about $77,000,000 in 1965 (on the assumption that the companies' proportionate holdings of tax-exempt bonds and corporate stocks remain at their present level) to an annual figure of $325,000,000 by 1970 (on the assumption that the companies undertake to minimize their future tax liabilities by adjusting the holdings in their portfolios). *Hearing Before The Senate Committee On Finance on H.R. 5739,* 88th Cong., 2d Sess., pp. 28–29.

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[7] Of the estimated revenue loss of $400,000,000 for the period 1958–1964, $180,000,000 is attributed to adjustments for tax-exempt interest and $220,000,000 to adjustments for corporate dividends received by life insurance companies. Sections 804 (a)(6) and 809(b)(4) require adjustments to prevent the "imposition of tax" not only with respect to tax-exempt interest, but also with respect to dividend income which qualifies for the "dividends received" deduction under §§ 243–245.

The volume of litigation threatened to be precipitated is almost equally imposing. The Treasury estimates that the decision below will result in up to 8,000 refund claims for past years alone, unless it is reviewed and the issue resolved with finality by this Court. It is thus of the greatest administrative, as well as fiscal, importance that this Court review the decision of the Tenth Circuit.

3. A decision of a lower court effectively invalidating a Congressional plan of taxation so plainly calls for review by this Court that an extended discussion of the merits is neither necessary nor appropriate. To show that the question is substantial, however, we will briefly indicate the nature of the issues.[8]

a. There is no dispute in this case as to how the statutory formula operates or the effect the receipt of tax-exempt interest has under it. The only question is: when is a tax a tax "on" municipal bond interest? The court of appeals' answer is a simple one: whenever the tax is greater than it would have been if the taxpayer had not received the tax-exempt interest, the amount of the increase in the tax is a tax "on" tax-exempt interest. In our view, that answer is too simple, and wholly fails to appreciate the essential ambiguity in identifying a tax determined by a computation involving many elements with any one of the elements. Suppose that a company has a $1,000,000 investment yield composed of $200,000 of each of five kinds of income: municipal bond interest, industrial bond interest, dividends, royalties, and rents. If the amount excluded as the policyholders'

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[8] For a fuller treatment, see Wurzel, *Tax-Exempt Interest of Life Insurance Companies*, 70 Yale L. J. 15 (1960).

share were $800,000, the court below would say that the entire tax determined under the statutory formula was a tax "on" the municipal bond interest, because without it there would have been no tax. But employing precisely the same reasoning, one can prove just as conclusively that the entire tax was "on" the dividends, or "on" the rents—in short, that it was "on" whichever one of the items one chooses to assert that it was on. The fact is that without any one of the items there would have been no tax, and the answer simply cannot be found, as the court of appeals tried to find it, in the rules of arithmetic.[9] Rather, like most questions of constitutional power, the answer must be found, not in mathematical abstractions, but in the reasonableness of the classifica-

[9] To demonstrate the same ambiguity in the context of the allocation of income between two shares, suppose that a trust has $10,000 income composed in equal parts of five kinds of income with differing tax consequences (capital gains, depletable income, tax-exempt interest, domestic dividends, and foreign tax-paid dividends). Under the trust instrument, the first $6,000 of income is to be distributed to *A*, the balance, which happens to be $4,000 in the year in question, to *B*. For tax purposes, which beneficiary receives which income? Must *B* be treated as receiving all of the tax-exempt interest because it is his share, and not *A*'s, that would have been reduced had it not been received (a statement equally true of each of the other kinds of income)? The statutory solution, not surprisingly, is identical to that adopted for life insurance companies: *A*, having received 60% of the total income, is deemed to have received 60% of each item (§ 662(a)(1) and (b)). Since the result is to make *B*'s tax greater than it would have been if the trust had not received the tax-exempt interest, is *B* being taxed "on" tax-exempt interest under the rationale of the court below? If the fact that *A* is also taxable be thought significant, would it make a difference if *A* had happened to be an exempt organization?

tions of income and the rules for attribution of expenses adopted by Congress.

In our view, the statutory formula is a reasonable exercise of Congress' power to classify income and expenses regardless of whether the addition to the reserve is treated as a division of income between co-beneficiaries or as a cost of producing income. If the policyholders are treated, on a trust analogy, as having a beneficial interest in the undivided part of the assets represented by the reserve liability, it can hardly be considered unreasonable to attribute to them a pro rata part of all the kinds of income derived from the investment of those assets. If, on the other hand, the addition to the reserve is viewed as a deduction representing a deferred cost incurred by the company in exchange for the use of the funds advanced to it by policyholders as premiums—represented by the reserve—the formula is still reasonable. Congress need not allow deductions for the "cost" of producing income which is itself tax-exempt. *Denman* v. *Slayton*, 282 U.S. 514. The question then is, which income was produced by the investment of the reserve funds "borrowed" from the policyholders at the "cost" of the annual addition to the reserve? There being no more reason to trace the "borrowed" funds into one kind of asset than another, it is surely both reasonable and fair—and within the competence of Congress—to treat the reserve funds as being used to buy and carry an equal fraction of all the assets, thus justifying a proportional denial of the deduction for the "cost" of using those funds (*i.e.*, in the same

proportion as the company's total funds are invested in producing tax-exempt interest).

b. So plainly reasonable is the method of allocation adopted by Congress that the only substantial question posed by this case is the scope to be given to the decisions in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, and *Missouri Insurance Co.* v. *Gehner,* 281 U.S. 313. If the opinions in those cases are read for the most that their language implies, they admittedly lend support to the decision below. Yet not only has the continuing vitality of those decisions—rendered over dissents by Justices Holmes, Brandeis and Stone (endorsed in principle by Chief Justice Hughes, see 281 U.S. at 322)—been cast in doubt by intervening developments in the law of inter-governmental immunities, but they are readily distinguishable on their facts and can hardly be deemed controlling here.

In *National Life,* the statute allowed a deduction for additions to the policyholders' reserves only to the extent that the additions exceeded the tax-exempt interest. It thus suffered from the same vice that characterizes the decision below: instead of a pro rata allocation, it arbitrarily allocated 100% of the tax-exempt interest to the reserves, just as the decision below arbitrarily allocates 100% of the tax-exempt interest to the company. The *Gehner* case, in turn, involved the invocation of the federal immunity from State taxation, an immunity which this Court has recognized to be broader than the immunity enjoyed by the States from federal taxation. See *New York* v. *United States,* 326 U.S. 572, 576–577. Just as im-

portantly, it involved a tax on property rather than one on income. A tax on the interest paid on bonds is already one step removed from a tax on the bonds themselves, and a tax the measure of which is affected by the interest received from tax-exempt bonds (this case) is therefore one step removed from a tax the measure of which is affected by the tax-exempt bonds themselves (*Gehner*).

The present statute, moreover, rather than limiting a deduction otherwise allowable (as did the statutes in those cases), treats a share of each item of income as "belonging" to the policyholders and therefore never includes that portion in the company's income. It may be that a truly sophisticated analysis (viewing deductions as equally an "appropriation" of income, albeit to pay "costs" rather than claims of beneficiaries) would see little difference between allocating items of income among beneficiaries and allocating deductions to items of income. If so, it would only reveal a lack of sophistication in the reasoning of *National Life* and *Gehner*, for there can be no quarrel that, at least in dividing income among co-beneficiaries, a pro rata allocation of each item of income is the only solution that has any claim to reason (see note 9, *supra*). Whether the income-division approach of the present statute serves to distinguish the prior cases or only to expose their fallacies, it makes evident the reasonableness of the statute's method of allocation, from which the conclusion that no tax is being imposed on municipal bond interest follows automatically.

CONCLUSION

For the reasons stated, this petition for a writ of certiorari should be granted.

Respectfully submitted.

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SEPTEMBER 1964.

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

March Term, 1964

No. 7424

ATLAS LIFE INSURANCE COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OKLAHOMA

May 25, 1964

Before MURRAH, *Chief Judge,* and BREITENSTEIN and HILL, *Circuit Judges*

MURRAH, *Chief Judge.*

The taxpayer, a life insurance company, appeals from a judgment of the District Court (Atlas Life Insurance Co. v. United States of America, 216 F. Supp. 457), denying refund of income taxes paid by it, pursuant to the Life Insurance Company Tax Act of 1959. 26 USC 801 et seq. The Act imposes a tax at ordinary corporate rates upon "life insurance com-

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pany taxable income" (§ 802(a)), based upon a three-phase calculation under Section 802(b), which, for our purposes, involves only the first two steps, namely: the determination of "taxable investment income" and "gain from operations" as defined in Sections 804 and 809, respectively.

The taxpayer computed and paid its income taxes for the year 1958 in accordance with the statutory definitions. It thereafter filed claim for refund, contending that the application of the statutory definitions "taxable investment income" and "gain from operations" resulted in the imposition of a tax on tax-exempt interest received from municipal bonds, and that it is therefore entitled to an adjustment under the provisions of Sections 804(a)(6) and 809(b)(4).

The Act of 1959 was promulgated in response to the recognized need for a more permanent and equitable method for determining taxable income of life insurance companies, and was the result of a comprehensive reappraisal of former legislation in the area. The formula for the determination of the tax was conceived in recognition of two salient principles of tax immunity: (1) the policy which has inhered in income tax law since its inception in 1913, to the effect that interest on state securities is excluded from gross income in the computation of the taxpayer's federal tax liability;[1] and (2) in recognition of the traditional concept that a life insurance company should not be taxed on that part of its income which is required to be set aside as a reserve to meet the company's contingent obligations to its policyholders. See 2 USC, Congressional and Administrative News, 86th

[1] This concept is presently embodied as a general rule in Section 103, 26 USC Sec. 103, but is not applicable to the tax treatment of life insurance company tax-exempt interest.

Congress, First Session, 1575; Wurzel, "Tax-Exempt Interest of Life Insurance Companies", 70 Yale L.J. 15 (1960).

The concept of "reserve deduction" is perpetuated in the Act by the division of each and every item of net investment income into two catergories; (1) the policyholders' share which is excluded from tax liability; and (2) the Company's share which is subject to taxation. To effectuate the division of the Company's share from the policyholders' share of the net investment income, the Act first provides for the determination of net investment income, i.e., "investment yield", or gross investment income, including tax-exempt interest, less certain expenses. See §§ 804(c), 804(a)(1) and 809(a)(1). The policyholders' percentage share of investment yield is determined by dividing investment yield into "policy and other contract liability requirements." § 804(a)(1). These requirements are calculated in accordance with the complicated formula provided in Section 805 by adding: the product of the company's "adjusted reserves rate"[2] and its "adjusted life insurance reserves";[3] the

[2] The "adjusted reserves rate" is the lower of the average earnings rate or the current earnings rate. § 805(b)(1) The "current earnings rate" is the investment yield divided by the mean of the company's assets. § 805(b)(2) The "average earnings rate" is the average of the current earnings rates for the taxable year and for each of the four preceding taxable years. § 805(b)(3).

[3] The "adjusted life insurance reserves" is the mean of life insurance reserves, other than pension plan reserves, adjusted upward by one percent for every tenth of a percent by which the "adjusted reserves rate" is less than the assumed interest rate used in calculating such reserves. If the "adjusted reserves rate" exceeds the assumed interest rate, the reserves are adjusted downward in a similar manner. § 805(c).

pension plan reserves multiplied by the current earnings rate;[4] and interest paid. The percentage derived from the use of this formula[5] represents the policyholders' percentage share, and the remaining portion of 100 percent is the company's percentage share. The life insurance company's percentage share of each and every item of investment yield is then reduced by its percentage share of tax-exempt interest,[6] and the result is taxable investment income.

The second phase for calculating the base tax, i.e., "gain from operations", follows a similar pattern in determining the policyholders' share of investment yield. Though the formula is different,[7] it is sufficient for our purposes to note that, as in phase one, the tax-exempt interest is included to determine the respective percentage shares, and the company's share of exempt interest is then deducted to arrive at gain from operations. See § 809. Thus, after the computation of tax-

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[4] See Footnote 2 for explanation.

[5] It is important to note that investment yield which includes tax-exempt interest is not only the denominator of this formula, but it also significantly affects the determination of the numerator.

i.e. $\frac{\text{policy and other contract liability requirements}}{\text{investment yield}}$

And See Footnotes 2 and 3.

[6] Other deductions are specified in § 804(a)(2)(A).

[7] The policy holders' percentage share of gain from operations is determined by dividing "investment yield" into "required interest" as defined in Section 809(a)(2) instead of "policy and other contract liability requirements." The company's share of each and every item of "investment yield" is then added to the net premium receipts which is reduced by specified deductions, including the company's share of tax-exempt interest. See § 809(d). The result is "gain from operations."

able investment income and gain from operations, Section 802(b) specifies their proper relationship to determine "life insurance company taxable income", i.e., the sum of taxable investment income and 50 percent of the excess of gain from operations over taxable investment income.

The Act then finally provides as an "exception" that "if it is established in any case that the application" of the definitions of taxable investment income and gain from operations "results in the imposition of tax on" any tax-exempt interest, "adjustment shall be made to the extent necessary to prevent such imposition." §§ 804(a)(6) and 809(b)(4).

Making application of the statutory formula in its return for 1958, the taxpayer first computed its tax liability to be $62,615.05. And, it does not now dispute the correctness of the calculations of its tax liability under the formula. The contention is rather that the application of the formula results in its tax liability being increased by $11,252.19, solely because of the receipt of tax-exempt interest and its inclusion in the determination of the tax base. The claim for refund is based on computation of the company's tax liability without the inclusion of tax-exempt interest in investment yield as used in the formula for determining the tax base.

An interpretative analysis of the table below[8] reveals the extent to which the inclusion or exclusion of

[8] This table illustrates the differential in the company's tax liability under the statutory formula and the taxpayer's computations of its liability based upon the exclusion of the tax-exempt interst from investment yield whenever it becomes operative under the formula. Neither party disputes the correctness of the arithmetic computations which reflect the

tax-exempt interest in or from investment yield permeates the whole computation of tax liability. Thus, in phase one, a reduction of the adjusted reserves rate results because it is the lower of the two earnings rates, which are in essence determined by dividing assets into investment yield. See Footnote 2. The effect of the reduction in the adjusted reserves rate on policy and other contract liability requirements is par-

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application of their respective theories of the company's statutory tax liability.

Phase 1: Computation of Taxable Investment Income

Item	Statutory formula	Exempt interest excluded
Investment Yield	$894,277.61	$857,639.82
Current Earnings Rate	3.33390%	3.19731%
Average Earnings Rate	3.253782%	3.12297%
Adjusted Reserve Rate	3.253782%	3.13397%
Adjusted Life Ins. Reserves Rate	$22,090,965.28	$22,375,659.00
Policy & Other Contract Liability Requirements	$763,144.28	$743,137.55
Policyholders' Percentage Share	85.3364%	86.6491%
Company's Percentage Share	14.6636%	13.3509%
Company's Share of Items of Investment Yield	$131,133.29	$114,502.27
Deduction of Tax-Exempt Interest	$5,372.42	none
Taxable Investment Income	$100,760.87	89,502.27

Phase 2: Computation of Gain from Operations

Item	Statutory formula	Exempt interest excluded
Investment Yield	$894,277.61	$857,639.82
Required Interest	781,540.32	781,540.32
Policyholders' Percentage Shares	87.39348%	91.1269%
Company's Percentage Share	12.60652%	8.8731%
Company's Share of Items of Investment Yield	$112,737.29	$76,099.50
Deduction of Tax-Exempt Interest	$4,618.75	none
Gain from Operations	$161,220.08	$129,201.04

Tax Computation

Item	Statutory formula	Exempt interest excluded
Taxable Investment Income	$100,760.87	$89,502.27
50% of the Excess of Gain from Operations over Taxable Investment Income	30,229.61	$19,849.39
Life Insurance Co. Taxable Income	$130,990.48	$109,351.66
Total Income Tax*	$62,615.05	51,362.86

*The $11,252.19 differential constitutes the claimed refund.

tially offset by the increase in the adjusted life insurance reserves caused by the greater difference between the adjusted reserves rate and the assumed interest rate. See Footnote 3. Although policy and other contract liability requirements are lower, the policyholders' percentage share is greater because of the exclusion of the exempt interest from investment yield. Conversely, the Company's percentage share is greater because of the inclusion of exempt interest in investment yield. Thus, the percentage differential and the ultimate increase of taxable items of investment yield included in taxable investment income are attributable to the inclusion of tax-exempt interest.

Similarly, in the phase two computation, exclusion of tax-exempt interest from investment yield results in an increased policyholders' percentage share, because it is calculated by dividing investment yield into required interest which remains the same. Thus, the difference in the Company's percentage shares is attributable to the inclusion of the exempt interest, and this in turn accounts for the variation in gain from operations.

The trial court's conclusion that the receipt by the taxpayer of exempt interest was not in fact taxed, is apparently based upon the interpretation of the statutory formula, to the effect that the "company's tax-exempt interest is included in gross income and then deducted before reaching the tax base of the Taxpayer." Atlas Life Insurance Co. v. United States of America, supra, p. 460. The fallacy of this interpretation is that it fails to recognize what the Government seems to concede, that the increase in the Company's share of investment yield by the inclusion of exempt interest in the formula for determining the respective percentage shares is not offset by the deduction of the Company's percentage share of exempt

interest, and that the ultimate tax liability is in fact increased.

The judgment of the trial court is sought to be sustained on the theory that although the inclusion of tax-exempt interest in the formula results in an increase in the Company's share of all other income, it will be exactly what it would have been if the Company had received taxable income, and that the application of the statutory definitions does not therefore result in a tax on tax-exempt interest. The Government says this is "precisely what Congress intended." And, they justify it by emphasizing the design of the statute to divide the ownership of all investment income, and that this has the concomitant effect of dividing the tax-exempt interest between the policyholders and the Company. This method of prorating the exempt interest is said to be an exertion of the "full power" of Congress to classify income for tax purposes, and in this particular case, to prevent a double deduction through the interplay of the exclusion of the policyholders' share and the deduction of exempt interest.

The Government attacks the taxpayer's formula which eliminates the exempt interest from the computation as in effect allocating all taxable dollars to the policyholders and all tax-exempt dollars to the Company, thus creating a loophole which the statute was designed to prevent.

If, as the Government contends, the Congress, in enacting the taxing formula, intended to test anew the doctrine of inter-governmental tax immunity by exerting its full constitutional powers to classify income for tax purposes, our inquiry is simply whether, judged by present-day concepts, the Congress overstepped its constitutional bounds. But, the taxpayer takes the position that Congress legislated with an

eye to the doctrine of National Life Insurance Co. v. United States, 277 U.S. 503; and Missouri v. Gehner, 231 U.S. 313, according to which the sovereign may not subject a taxpayer to a greater burden on his income solely because of the receipt of tax-exempt interest. As we view our lawsuit in the context of the respective contentions of the parties, it involves the determination of the extent to which the Congress intended to exercise its power of taxation with respect to tax-exempt interest received by life insurance companies.

While resort to legislative history is usually justified only in cases of ambiguity in the statutory language, i.e., see Nicholas v. Denver & R.G.W. R. Co., 195 F. 2d 428, it is frequently relied upon for the ascertainment of a Congressional purpose as embodied in the final enactment. See Flora v. United States, 362 U.S. 145; United States v. Harriss, 347 U.S. 612; United States v. American Trucking Assn., 310 U.S. 534; Caminetti v. United States, 242 U.S. 470; Sutherland on Statutory Construction, Vol. 2, p. 481 et seq. In the words of Mr. Justice Frankfurter, dissenting in Reed v. Pennsylvania RR Co., 351 U.S. 502, 510, "The process of judicial construction must be mindful of the history of the legislation, of the purpose which infused it, of the difficulties which were encountered in effectuating this purpose, of the aims of those most active in relieving these difficuties." To support their positions, both the Government and the taxpayer rely heavily on the extensive legislative history of the Act as influenced by the contemporary case law. We will therefore examine it to determine the purpose and scope of the taxing act.

The parties start with the Revenue Act of 1921 and particularly Section 245(a), 42 Stat. 227, 261, which provided that in the case of life insurance companies,

net income means gross income less certain deductions, inter alia, (1) the amount of interest received from tax-exempt securities; and (2) a reserve deduction reduced by the amount of exempt interest. In National Life Insurance Co. v. United States, supra, the Supreme Court held that the diminution of the reserve deduction by the amount of exempt interest had the effect of destroying the guaranteed exemption. The underlying principle, as announced by the Court, was to the effect that a taxpayer may not be subject to a greater tax burden on his taxable income solely by reason of the receipt of tax-exempt interest.

There were strong and persuasive dissents in which it was suggested that since the reserve deduction was a matter of grace or bounty, the Congress was perfectly free to reduce it by the amount of exempt interest, or any other amount for that matter. The dissenters did not think that the Constitution or the laws guaranteed that "a holder of tax-exempt bonds, shall be better off than if he held only taxable securities"; nor did it require that "those who do not hold tax-exempt securities shall, in respect to every tax, be subjected to a heavier burden than the owners of tax-exempt bonds." National Life, supra, p. 528.

Apparently, on the authority of National Life, the Supreme Court in Missouri v. Gehner, supra, reversed the Missouri Supreme Court which, in considering a state property tax, had upheld the apportionment of reserves and claims between taxable and non-taxable assets, including United States bonds. The Court restated the National Life doctrine to the effect that a "State may not subject one to a greater burden on his taxable property merely because he owns a tax-exempt government securities." Missouri v. Gehner, supra, p. 321. The same dissenters, speaking through Mr. Justice Stone in Gehner, were of the opinion that

nothing in National Life required a reversal of this case. They insisted that tax-free securities might well be realistically held accountable for their share of reserves for claims in computing the tax. Otherwise, said they, an affirmative benefit is conferred upon the ownership of tax-exempt securities "at the expense of the taxing powers of the state, by relieving the owner from the full burden of taxation on net worth to which his taxable assets have in some measure contributed." Gehner, supra, p. 328. It would thus appear that the dissenters would have given little or no respect to the doctrine of intergovernmental tax immunity. In any event, it seems reasonable to say that the same vigorous dissenters in both National Life and Gehner would find no fault in the asserted power to apportion tax-exempt income between the reserve deduction and taxable income for the purpose of arriving at the taxpayer's tax liability.

Another contemporary decision of the Supreme Court, Denman v. Slayton, 282 U.S. 514, also involved the 1921 taxing Act, particularly Section 214(a)(2), 42 Stat. 227, 239, which denied a deduction for interest paid on indebtedness incurred to purchase or carry tax-exempt securities. In his return for the taxable year 1922, the taxpayer excluded interest received on tax-exempt muncipal bonds and deducted the interest on money borrowed to purchase and carry the bonds. The Commissioner disallowed the deduction and the lower court sustained the taxpayer on the authority of National Life. But, a unanimous Supreme Court, in an opinion by the writer of National Life, held that National Life was "radically different", and that its doctrine did not control. The Court went on to say that "while guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the

payment of his just share of a burden fairly imposed." Denman v. Slayton, supra, p. 519.

Such was the state of the decisional law as Congress continued to wrestle with the problem of finding a just and appropriate method of determining life insurance companies' taxable income. The 1921 Act apparently was not amended to reflect the National Life restriction on reserve deduction until the 1932 Act, which simply deleted the objectional provision for diminution of the reserve deduction by the amount of exempt interest. 47 Stat. 169, 224; § 203 of Revenue Act of 1932. This text of the law was carried forward and observed until 1942 when a new system was introduced. 56 Stat. 798, 868–870, §§ 202 and 203 of the Revenue Act of 1942. This Act prescribed a reserve deduction expressed as a percentage of investment income, including tax-exempt interest based on industry-wide experience. Each company applied this percentage to its net investment income, but was allowed to deduct all its tax-exempt interest before prorating its net investment income.

As in our formula, the 1942 Act included exempt interest in its formula for determining the industry-wide reserve deduction percentage. And, this percentage, which was applied to determine the individual company reserve deduction, was decreased by the inclusion of tax-exempt interest. This had the theoretical effect of increasing the percentage of net investment income which is taxable. But no taxpayer was induced to test the added tax burden as against the doctrine of National Life, apparently for two reasons: (1) the industry-wide reserve deduction percentage was so great that the individual company's net taxable investment income was minuscule; (2) each company could minimize its tax burden by purchasing tax-exempt securities because the income

therefrom was not included in the computation of their individual tax liability. This situation obtained without significant change until 1958. See Wurzel, Yale L.J., supra, p. 20–21.

After considerable study, the House passed a Bill which provided for the determination of insurance company tax liability in three steps on an individual company basis. The step one base was the difference between the taxable net investment income, as reduced by the total amount of exempt interest, and the reserve deduction, as reduced by its allocable share of exempt interest. See: §§ 804 and 805, H.R. 4245, Hearings Before Senate Finance Committee on H.R. 4245, 86th Cong., First Sess. (1959), pp. 4–7. The provisions of the House Bill in this regard are noticeably similar to the so-called "Add-Back" provisions of Section 245(a)(2) of the 1921 Act, the distinction being that the reserve deduction was not diminished by the total amount of exempt interest, but only its prorata share. It is also noteworthy that the mathematical result of the House formula is conceded by all parties to be identical with the result obtained in the final Act.[9] The insurance companies apparently did not detect the shades of the 1921 Act in the House Bill until it came before the Senate. It was then that they apparently became aware that their tax liability might be increased solely by reason of the receipt of tax-exempt interest.

When the Treasury came before the Senate Finance Committee to urge the adoption of the House Bill, the Treasury witness, explaining the provisions of the proposed legislation, observed that while the tax-exempt interest was excluded in both phases of the

[9] The formula for step 2 proceeded along the same lines and, with a result also identical to the final Act. See: § 809, H.R. 4245, Hearings, supra, pp. 8–10.

Bill, an adjustment was made "to the deductions to avoid a double benefit * * *." He also agreed that it was "probably a fair statement" to say that the adjustment was in reality charging a part of the operating expense against tax-free interest. When asked why the Treasury proposed to tax-exempt interest, "even partially", the witness candidly answered: "Because we think it is right." In answer to further queries whether such a provision would render the bill unconstitutional, the witness also candidly admitted that he thought the question "might very well be litigated", and that "we should determine with the best advice we can, as to whether or not we today think such a provision is unconstitutional, and if we believe it is not, and if we believe the provision is right, we ought to include it in the bill." Hearings, supra, pp. 43–44.

The extensive pro and con hearings before the Senate Finance Committee on the House Bill reflect strong representations on the part of insurance companies and those interested in the marketability of tax-exempt securities, to the effect that the proration of the tax-exempt interest between the reserve deduction and net investment income resulted in a tax burden on exempt interest, contrary to National Life, and was therefore constitutionally impermissible. In short, they rested their case principally on the constitutional limitations of National Life and Gehner.[10] There was the further strong representa-

[10] One witness, president of a large life insurance company, in his statement purported to represent 120 companies; "We believe that, in its treatment of tax-exempt interest, H.R. 4245 contravenes the decision of the Supreme Court in the case of National Life v. United States. We think that if it was unconstitutional to add back 100 percent of tax-free interest to the tax base under the 1921 law, then adding back only 70

tions that the resultant burden on the exempt security would adversely affect their marketability in competition with taxable securities—a result which Congress would wish to avoid."[11]

As we summarize the Government's representations to the Senate Committee, they were based primarily on the thesis that the trend of the recent Supreme Court decisions was away from the National Life doctrine of intergovernmental tax immunity, and toward the minority view; that in any event, the House Bill formula was unlike the 1921 formula, and in substance the same as the 1942 formula, which

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percent of such interest is unconstitutional, too." Hearings, supra, p. 305. He also filed a lawyer's brief on the constitutional question. See Hearings, p. 308.

Another witness, vice-president of a life insurance company, stated that "As H.R. 4245 now stands, it is not possible for a life insurance company to invest either its capital or surplus funds in municipal bonds and receive the interest on them free from tax; at least, not unless it first invests all of its policyholders' reserve funds in municipal bonds. And this would be absurd." Hearings, supra, p. 406. He too supplemented his testimony with a memorandum on the constitutionality of taxation of tax-exempt interest, in which it was "observed that the pro rata disallowance rule under the Ohio (sic) statute which was held unconstitutional in the Missouri v. Gehner case is very similar to the pro rata rule contained in Section 809(d) of the present bill." Hearings, supra, 408.

See also: Hearings, supra, pp. 614, 632.

[11] The executive director of an association representing 13,000 municipal governments submitted a statement in which H.R. 4245 was characterized as "* * * the opening wedge to apply the same principal to all other taxpayers." It also noted the "* * * * higher interest rates which State and local governments would have to pay if such a Federal tax were imposed on all their bonds in the future." Hearings, supra, p. 699. An association composed of 6,000 county officials endorsed this statement. See Hearings, supra, p. 699–700.

See also Id., p. 106, 187–188, 252, 305, 405, 632, 687.

had the effect of preventing a double deduction for tax-exempt interest, and which had never been challenged in the courts. See: Hearings, supra, p. 48–51.

It is not manifestly clear what considerations prompted the Senate Committee to revise the House Bill, but the fact is that it did reapproach the problem somewhat differently with respect to the treatment of tax-exempt interest. One of the innovations deemed important in the Senate version was division of the ownership of income and expense items between the policyholders and the insurance company, with only the company's share being taken into account for tax purposes. See: 2 USC Cong. & Adm. News, supra, p. 1580. The Senate Committee seemed to think that by dividing ownership of investment income by the use of a formula which included all tax-exempt interest, and the deduction of the company's pro rata share from its tax base, was preferable to the House formula, which excluded all tax-exempt interest from investment income, but reduced the deduction for policy and other contract liability requirements by its pro rata share of exempt interest.[12]. Apparently, being unsure of the tax consequences of what they had done, but "to give further assurance that no tax is to be imposed on tax-exempt interest", the Senate then added the exception Sections

[12] After comparing the two treatments, the Committee Report added: "Your committee believes that the division of income and expense items between the policyholders and the insurance company, with only the latter being taken into account for tax purposes, is a much better concept to follow. It also makes it clear that items which are properly exempt * * * such as tax-exempt state and municipal bond interest * * * are properly divided between the policyholders and the life insurance company and that as far as the latter is concerned, namely, the only portion included in the tax base, full allowance is made for these items." 2 USC Cong. & Adm. News, p. 1580.

804(a)(6) and 809(b)(4). 2 USC Cong. & Adm. News, supra, p. 1592.

When the Senate version came to the Floor for consideration the Chairman of the Finance Committee, reporting on the Bill, stated that it was "the intention of the Committee not to impose any tax on tax-exempt interest"; and that the "Treasury has assured the Committee that this formula does not impose any tax on tax-exempt interest. The bill adds a proviso to the effect that if the formula I have described does not result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so." [13]

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[13] Senator Curtis, who was asked to make the detailed explanation of the statute, made the following statement on the floor of the Senate before the amended version was adopted: "I wish to mention a matter which has deeply concerned your committee. That was the problem of making sure that we did not, by inadvertence, tax any of a life insurance company's tax-exempt interest income. The bill meets this problem most accurately and fairly." He concluded his discussion of the treatment of tax-exempt interest with the following example: "Under the bill, $70 of the $100 tax-exempt interest income would be allocated to policyholders' reserve, and the other $30 would be allocated to the company. Since no part of the policyholders' reserves would become a part of the tax base, no part of the $70 tax-exempt interest allocated to those reserves would be taxed. Moreover, no part of the $30 allocated to the company would be taxed, because a deduction of the full $30 would be made in determining what part of the company's share of its investment income was to be subject to tax.

"Thus, no tax-exempt income or credits of life insurance companies will be included in the tax base of such companies, under this bill. This should allay any fear that any constitutional provision is transgressed." 105 Cong. Record, Part 6, p. 8429. Representative Mills, after the conference committee reached agreement on the final Act, reported to the House: "It is my belief that the appropriate deduction was allowed by the House bill and that these provisions of the final bill, which closely follow the Senate amendments, make no change of sub-

105 Cong. Record, Part 6, p. 8401. A letter from the Treasury, read to the Senate, stated that "It has been the objective of the provisions in question to exclude fully from tax in the hands of life insurance companies the interest on State and municipal bonds. At the same time, however, it has been considered essential not to allow anything in the nature of a double deduction or tax loophole arising from the special characteristics of the unique formula to be applied to these companies." The letter again reviewed the statutory formula for determining an insurance company's taxable income and, referring to the exception sections, expressed the view that "this additional language is not necessary, since we cannot envision a situation in which the operation of the proposed tax formula would result in the substantive imposition of tax on municipal bond interest or on any other form of tax-exempt income." 105 Cong. Record, Part 6, p. 8402. What the Treasury meant by a "substantive imposition" of tax on exempt interest is a matter of doubt and speculation. But, considered in the context of the views expressed before the Committee, and the position taken here, it seems fair to assume that the Treasury recognized that though the inclusion of tax-exempt interest in the formula resulted in an increase of the taxpayer's burden, it was nevertheless within the taxing power of the Congress and would not therefore result in an impermissible imposition, and we consequently have no need to employ the exception provisions of the statute.

Whatever may be said of the extent of the Congressional power to indirectly burden exempt interest in

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stance." 105 Cong. Record, Part 8, p. 10412. He further stated that the final Act "* * * clarified the language of the House bill to make it definite that we do not intend to tax the interest on tax-exempt securities." Id., 10414.

the exercise of its power to classify all income for purposes of taxation; and whatever may be said of the government's conception of the Congressional intent and purpose to observe those precepts in the enactment of this legislation, it seems manifestly plain to us that Congress did not intend to invade the integrity of the intergovernmental tax immunity doctrine as exemplied in the decisional law when the legislation was under consideration. The prenatal history of this Act convinces us that Congress legislated with an ear to the problem of the marketability of state and municipal securities, and with an eye to the constitutional limitations of National Life on the Congressional power to increase the tax burden of a life insurance company, solely by reason of the receipt of interest from state or municipal securities.

The question then is whether this is a National Life-Gehner case. The trial court did not think so, and, basing its decision on Slayton, concluded that there was in fact no imposition of a prohibited tax. We conclude that our case is within the ambit of the National Life case, which is "radically different" from Slayton. In National Life, the Court invalidated Section 245(a) of the 1921 Act because it in effect increased the taxpayer's tax liability, solely by reason of the receipt of tax-exempt interest. In Slayton, the same Court upheld Section 214(a) of the same Act as a valid measure to prevent the avoidance of tax on taxable income by the simple expedient of borrowing to purchase tax-exempt securities. As the Court observed in Slayton, the taxpayer "was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of Section 245(a)." Denman v. Slayton, supra, 519.

And see Helvering v. Independent Life Insurance Co., 292 U.S. 371, 381.

While the extent of the burden on the exempt interest and the form and method of imposing it in our case may differ from National Life, the taxable effect differs only in degree. In both instances the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest, and no form or method for determining it can disguise its incidence. We conclude that the application of the definitions in the Act does result in the imposition of a tax on exempt interest, and the taxpayer is therefore entitled to an adjustment to the extent necessary to prevent such imposition.

It is incumbent upon the taxpayer to prove the amount of the adjustment. It says that it is $11,252.19, and arrives at this amount by simply eliminating exempt interest wherever it is operative in the computation under the statutory formula. While the Government does not quarrel with the taxpayer's arithmetic, it strenuously denies support or sanction of the formula by which it is computed. In that respect it says that the treatment of the tax-exempt interest is the same as if the money used to purchase tax-exempt securities had remained idle.

Be that as it may, the Congress has expressly provided for an adjustment to the extent necessary to prevent the imposition of tax on the exempt interest. And, since we hold that the application of the statutory definitions does in fact result in a prohibited imposition; and since the taxpayer's computations are based upon the elimination of that interest, we must conclude that the adjustment does no more than prevent the prohibited imposition.

Insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

BREITENSTEIN, *Circuit Judge* (concurring in result).

I find it unnecessary to go into the details of the mathematical formulas provided by §§ 804 and 809 of the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. §§ 801–820, or to explore the legislative history of that Act.

Income of the companies subject to the Act is divided into a policyholders' share and a company's share. The company is taxed on its share. The uncontroverted showing of Atlas is that, on the facts pertaining to its 1958 income, the inclusion of interest on tax-exempt securities in the statutory formulas increases the company's share and results in a tax of $11,252.19 more than would have been payable if tax-exempt income had been excluded therefrom. The imposition of tax in this amount results solely from the inclusion in the formulas of income from tax-exempt securities.

Both § 804(a)(6), relating to taxable investment income, and § 809(b)(4), relating to gain from operations, provide that if the application of the definitions found in those sections results in the imposition of a tax on interest which under § 103 is excluded from gross income (interest on state, municipal, and certain other securities), "adjustment shall be made to the extent necessary to prevent such imposition."

The operation of the formulas is such that the tax actually is imposed on taxable income, but this result does not excuse the United States for failing to make the adjustment. National Life Insurance Company v. United States, 277 U.S. 508, and Missouri ex rel. Missouri Insurance Company v. Gehner, 281 U.S. 313, hold that a tax is imposed on tax-exempt property by an increase in tax on taxable property arising solely from the ownership of tax-exempt property.

I grant the power of Congress to classify income, within constitutional limits, for income tax purposes;

and I recognize that the reserve deduction which comes from the division of income into the noted shares is a matter of congressional grace or bounty. The issue is the exercise of a power rather than the existence of a power. The statute under consideration discloses a clear intent not to tax income from state and municipal securities. No uncertainty in this regard exists to require recourse to legislative history for the ascertainment of congressional intent.

We are bound by the National Life and Missouri v. Gehner decisions. With full knowledge of those decisions, Congress provided that if the application of the statutory method causes a tax on tax-exempt income an adjustment shall be made to prevent such a result. By refusing to make the necessary adjustment the government, in effect, has written §§ 804(a)(6) and 809(b)(4) out of the statute. Atlas is entitled to recover the overpayment.

JUDGMENT

First Day, May Term, Monday, May 25th, 1964

Before Honorable ALFRED P. MURRAH, *Chief Judge*, and Honorable JEAN S. BREITENSTEIN and Honorable DELMAS C. HILL, *Circuit Judges*

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

APPENDIX B

Internal Revenue Code of 1954, as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, 26 U.S.C. 1958 ed., Supp. V.

SEC. 103. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) *General Rule.*—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

* * * * *

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

* * * * *

(b) *Life insurance reserves defined.*

(1) *In general.*

For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves must be required by law.*

* * * * *

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

* * * * *

SEC. 802. TAX IMPOSED.

(a) *Tax Imposed.*—

(1) *In general.*—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

* * * * *

(b) *Life Insurance Company Taxable Income Defined.*—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount substracted from the policyholders' surplus account for the taxable year, as determined under section 815.

* * * * *

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) *In general.*—

(1) *Exclusion of policyholders' share of investment yield.*—The policyholders' share of each and every item of investment yield (including tax-exempt in-

terest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) *Taxable investment income defined.*—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equal 100 percent.

* * * * *

(6) *Exception.*—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

* * * * *

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. * * *

* * * * *

SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) *In General.*—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) *Adjusted Reserves Rate and Earnings Rates.*—

(1) *Adjusted reserves rate.*—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) *Current earnings rate.*—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) *Average earnings rate.*—

(A) *In general.*—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

* * * * *

(4) *Assets.*—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. * * *

* * * * *

(c) *Adjusted Life Insurance Reserves.*—

(1) *Adjusted life insurance reserves defined.*—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rates.

(2) *Average interest rate assumed.*—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

* * * * *

SEC. 809. IN GENERAL.

(a) *Exclusion of Share of Investment Yield Set Aside for Policyholders.*—

(1) *Amount.*—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any items set aside for policy holders shall be 100 percent.

(2) *Required interest.*—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d);

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

* * * * *

(3) *Life insurance company's share.*—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) *Exception.*—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

* * * * *

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

* * * * *

(8) *Tax-exempt interest, dividends, etc.*—

(A) *Life insurance company's share.*—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

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